

## Message Text

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PAGE 01 SANTIA 06561 01 OF 02 102228Z

ACTION ARA-14

INFO OCT-01 ISO-00 EB-08 AID-05 CIAE-00 COME-00 FRB-03

INR-07 NSAE-00 USIA-06 TRSE-00 XMB-02 OPIC-03

SP-02 LAB-04 SIL-01 OMB-01 NSC-05 SS-15 STR-04

CEA-01 /082 W

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R 102038Z AUG 77

FM AMEMBASSY SANTIAGO

TO SECSTATE WASHDC 6014

INFO AMEMBASSY BUENOS AIRES

AMEMBASSY MONTEVIDEO

AMEMBASSY ASUNCION

AMEMBASSY BRASILIA

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E.O. 11652: N/A

TAGS: ECON XM CI

SUBJECT: CHILE ECONOMIC ALERT REPORT

REF: STATE 180067

1. SUMMARY. CURRENT GOC ECONOMIC POLICY AIMS AT (A) THE ACHIEVEMENT OF SUSTAINED GROWTH RATE PRINCIPALLY THROUGH DEVELOPMENT OF A STRONG EXPORT SECTOR AND (B) REALLOCATION OF RESOURCES TOWARDS THOSE AREAS THAT ENJOY A COMPARATIVE ADVANTAGE. IN FURTHERANCE OF THIS POLICY THE GOC HAS DECREED A NEW FOREIGN INVESTMENT STATUTE AND TARIFF SCHEDULE AND REFINED ITS MONETARY AND FISCAL POLICY TO COMBAT PROBLEMS SUCH AS ENDEMIC INFLATION, AND LARGE DEBT SERVICE -- BUT AT THE COST OF HIGH INITIAL UNEMPLOYMENT. THE SHORTRUN OUTLOOK TO AUGUST 1978 IS FOR CONTINUED DECLINES IN THE RATES OF INFLATION AND UNEMPLOYMENT, AND FOR A RATE OF GROWTH OF 7 PERCENT. THE WINDING DOWN OF THE AID PROGRAM, AND THE RELATIVE PAUCITY OF US INVESTMENT, AND OUR RELATIVE SELF-SUFFICIENCY IN COPPER MITIGATE THE IMPACT OF GOC ECONOMIC POLICY ON U.S. INTERESTS AT THE PRESENT TIME. END

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PAGE 02 SANTIA 06561 01 OF 02 102228Z

SUMMARY.

2. MAJOR ECONOMIC PROBLEMS:

(A) INFLATION: CHILE HAS HISTORICALLY SUFFERED INFLATION RATES AROUND 30 PERCENT. AS A RESULT OF STRINGENT ECONOMIC MEASURES OVER THE PAST TWO YEARS. INFLATION IN 1977 IS EXPECTED TO AVERAGE OUT AT

70 PERCENT, DOWN FROM 174.3 PERCENT IN 1976 AND A PEAK WHICH MAY WELL HAVE REACHED 1000 PERCENT AT THE END OF 1973. AT THE PRESENT RATE OF DECLINE, THIS WOULD BRING THE RATE DOWN A FURTHER 20 PERCENT OVER THE NEXT TWELVE MONTHS. AS THE RATE MORE CLOSELY APPROXIMATES THE HISTORICAL AVERAGE, IT IS LIKELY THAT THE RATE OF DECREASE WILL BE SLOWED PROPORTIONALLY.

(B) ECONOMIC RATIONALIZATION. THE PRESENT GOVERNMENT FELL HEIR TO THE RESULTS OF 40 YEARS OF AUTARCHIC, IMPORT-SUBSTITUTION ECONOMIC POLICY, IN WHICH SHORT-TERM CONSIDERATIONS OF HIGH CONSUMPTION AND EMPLOYMENT OUTWEIGHED THOSE OF PRODUCTIVITY. INEFFICIENCY WAS MASKED BY HEAVY FOREIGN BORROWING AND FOREIGN AID. BEHIND A TARIFF WALL, AND ABSENT DOMESTIC COMPETITION, INDUSTRIES PROLIFERATED WHOSE PRODUCTS WERE GENERALLY HIGHER IN COST AND LOWER IN QUALITY THAN THOSE AVAILABLE INTERNATIONALLY. MORE RECENTLY, EXTENSIVE EXPROPRIATION OF FARM LAND RESULTED IN INEFFICIENT LAND USE PATTERNS. WITH THE NEW REGIME'S EMPHASIS ON A FREE MARKET, AND ON PRINCIPLES OF EFFICIENCY AND COMPARATIVE ADVANTAGE, AGRICULTURAL RECOVERY HAS BEGUN. CHILE'S EXPORTS INCREASINGLY INCLUDE AGRICULTURAL AND OTHER NON-TRADITIONAL PRODUCTS. IMPORTS OF CAPITAL AND CONSUMER GOODS ARE WELL ABOVE CY76 LEVELS. THE GROWTH IN IMPORTS IS PARTLY DUE TO DECREASING TARIFF RATES WHICH BY 1978 WILL BE LIMITED TO A RANGE OF 10-35 PERCENT, WITH FEW EXCEPTIONS. MANY PUBLIC ENTERPRISES HAVE BEEN RETURNED TO THE PRIVATE SECTOR WHILE THOSE STILL IN PUBLIC HANDS HAVE LOST THEIR AUTOMATIC ACCESS TO PUBLIC SUBSIDY. A NUMBER OF INEFFICIENT INDUSTRIES, BOTH PUBLIC AND LIMITED OFFICIAL USE

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PAGE 03 SANTIA 06561 01 OF 02 102228Z

PRIVATE, EXPOSED TO INTERNATIONAL COMPETITION, UNDERFINANCED, AND UNABLE TO PAY VERY HIGH INTEREST CHARGES, WILL PROBABLY FOLD.

(C) INVESTMENT. THE LEVEL OF DOMESTIC INVESTMENT, 12 PERCENT IN 1976, REMAINS UNSATISFACTORY. HIGH DOMESTIC INTEREST RATES, THE RESULT OF A CONSTRAINED MONEY SUPPLY, COUPLED WITH AN INFLATIONARY PSYCHOLOGY, ARE PART OF THE EXPLANATION. THE ANTI-INFLATIONARY PREOCCUPATION OF THE GOVERNMENT IS ANOTHER. CHILE'S COPPER RESERVES, POSSIBLY THE WORLD'S RICHEST, HAVE ATTRACTED SEVERAL US AND CANADIAN INVESTORS, AND SHOULD BRING IN MORE. A REVISED FOREIGN INVESTMENT LAW OFFERS ADDITIONAL INCENTIVES. WHILE THE US DOES NOT DEPEND ON IMPORTED COPPER, WE MAY WELL HAVE A LONG RANGE NATIONAL INTEREST IN THE DEVELOPMENT OF FRESH SOURCES OF SUPPLY, IN ORDER TO KEEP WORLD PRICES STABLE IN THE FACE OF RISING DEMAND. EXCEPT FOR INVESTORS IN MINERALS, AND POSSIBLY IN INDUSTRIES DESIGNED FOR EXPORT TO CHILE'S NEIGHBORS, THE RELATIVELY SMALL SIZE OF THE CHILEAN DOMESTIC MARKET OFFERS LIMITED INCENTIVES TO US INVESTORS.

(D) BALANCE OF PAYMENTS. THE MASSIVE INTERNATIONAL DEBT INHERITED FROM EARLIER REGIMES HAS BEEN SERVICED AT THE EXPENSE OF OTHER IMPORTANT POLICY CONSIDERATIONS. DOMESTIC DEMAND WAS CUT BACK; EXPORT EARNINGS THAT MIGHT HAVE GONE INTO CAPITAL GOODS FOR

INVESTMENT, OR ANTI-INFLATIONARY IMPORTS, WERE PREEMPTED FOR DEBT

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PAGE 01 SANTIA 06561 02 OF 02 102231Z  
ACTION ARA-14

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LIMITED OFFICIAL USE SECTION 2 OF 2 SANTIAGO 6561

SERVICE PAYMENTS, AMOUNTING TO SOME \$800 MILLION A YEAR. AS A RESULT, CHILE'S PAYMENTS CAME INTO BALANCE, RESERVES MOUNTED, AND ITS RESULTING EXCELLENT BANKING REPUTATION HAS MADE POSSIBLE SOME REFINANCING ON MORE FAVORABLE TERMS. NEVERTHELESS, HIGH INTERNATIONAL PETROLEUM PRICES, AND THE CONTINUED DEPRESSION IN COPPER PRICES COUNINUE TO BEAR WATCHING. AN AVERAGE ANNUAL PRICE OF 60 CENTS PER POUND IS REQUIRED TO SUSTAIN BOP EQUILIBRIUM. IF THE PRESENT SPOT PRICE OF 54.5 CENTS PERSISTS, GOC POLICY MIGHT HAVE TO BE MODIFIED ACCORDINGLY. THE DRAMATIC VARIATION IN COPPER PRICES HAS, HOWEVER, HAD THE USEFUL EFFECT OF FORTIFYING THE RESOLVE OF THE GOC TO DEVELOP MEASURES TO DECREASE ECONOMIC DEPENDENCE ON COPPER IN ORDER TO PROTECT THE GENERAL ECONOMIC WELL-BEING FROM THE VARGARIES IN FOREIGN EXCHANGE EARNINGS. IN THIS REGARD, FURTHER ECONOMIC POLICY REINFORCEMENTS AIMED AT ENLARGING THE NON-TRADITIONAL EXPORT SECTOR MAY BE ANTICIPATED.

(E) CHILE'S INTERNATIONAL IMAGE. THERE WERE SOUND ECONOMIC REASONS FOR CHILE TO WITHDRAW FROM PARIS CLUB DEBT RESCHEDULLING. HOWEVER, WORLD CRITICISM ON HUMAN RIGHTS GOUNDS, BESIDES DETERRING LIMITED OFFICIAL USE

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PAGE 02 SANTIA 06561 02 OF 02 102231Z

INVESTORS, RESULTED IN A PREMATURE TERMINATION OF US AID.

(F) UNEMPLOYMENT. ALL THE ABOVE PROBLEMS AND POLICIES COMBINED TO LEVY A TOLL ON CHILE'S LABOR FORCE OF 3.2 MILLION. AT PRESENT, 13.0 PERCENT OF THE GREATER SANTIAGO LABOR FORCE IS UNEMPLOYED, DOWN FROM A HIGH OF 19-20 PERCENT A YEAR AGO. REAL WAGES, KEPT STABLE THROUGH READJUSTMENT AND FIXING SOME BASIC PRICES, HAVE YET TO REACH 1970 LEVELS. LABOR UNIONS ARE NOT FREE NOR MAY THEY STRIKE OR BARGAIN COLLECTIVELY. THE GOC HAS SOUGHT TO MITIGATE THE HARSH SOCIAL EFFECTS OF ITS ECONOMIC POLICY THROUGH SUCH MEASURES AS A PUBLIC WORKS PROGRAM WHICH PROVIDES MINIMAL EMPLOYMENT TO APPROXIMATELY 223,000 PERSONS (NOT INCLUDED IN UNEMPLOYMENT FIGURE). SIMILARLY, WITHIN AN AUSTERITY BUDGET, THE GOC IS TRYING TO INTRODUCE VOCATIONAL TRAINING PROGRAMS DESIGNED TO OVERCOME STRUCTURAL UNEMPLOYMENT PROBLEMS (UNSKILLED AND MARGINAL LABOR).

3. CRITICAL POINTS. WHILE THE LEVEL OF UNEMPLOYMENT HAS FALLEN 7 PERCENTAGE POINTS SINCE 1976 THERE IS CONCERN OVER WHETHER INVESTMENT LEVELS, EXPORTS AND ECONOMIC ACTIVITY GENERALLY ARE GROWING FAST ENOUGH TO BRING UNEMPLOYMENT DOWN TO ACCEPTABLE LEVELS (6-8 PERCENT). THE CHILEAN ECONOMY HAS EXPANDED SLOWLY AND STEADILY SINCE THE FIRST POLICY RESULTS WERE FELT IN 1976. EVEN IF PRESENT LACKLUSTER COPPER PRICES (55-60 CENTS PER POUND) CONTINUE, THE GOC ESTIMATES THAT ITS RESERVES ARE SUFFICIENT TO MAKE UNNECESSARY ANY FUNDAMENTAL CHANGES IN ITS POLICIES THROUGH DECEMBER 1978. SOME CRITICS ARGUE, HOWEVER, THAT WITH CONTINUED 55 CENT COPPER, A SERIOUS DEFICIT COULD RESULT BY DECEMBER 1977, LEADING TO DEVALUATION AND POSSIBLY LIMITATIONS ON CHILE'S SWELLING IMPORTS. WE TEND TO BE A LITTLE MORE OPTIMISTIC THAN THE CRITICS, AND FORESEE CONTINUED AND INCREASING OPPORTUNITIES FOR U.S. TRADERS AND INVESTORS. THIS WOULD PRESENT THE USG WITH POLICY DECISIONS REGARDING THE RAISING OF PRESENTLY CONSTRAINED EXIMBANK GUIDELINES. ASSUMING A PARALLEL LIMITED OFFICIAL USE

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PAGE 03 SANTIA 06561 02 OF 02 102231Z

IMPROVEMENT IN THE POLITICAL CLIMATE, IT WOULD ALSO ENTAIL THE INAUGURATION OF OPIC PROGRAMS.  
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## Message Attributes

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